EXHIBIT I

FINANCIAL TERMS AND CREDIT ANALYSIS

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The size and type of loan under request typically determines the scope of the financial review required to make a sound credit recommendation. A distinction should be made between short-term, intermediate and long-term loans. This is true for the financial review, collateral, terms and conditions of the loan and other factors.

The intended use of the proceeds, economic life of the asset being financed, collateral for the loan and source of funds for repayment determine the term of the loan.

Short-term Loans: Short-term loans are used to meet temporary or seasonal needs of a business. The term extended is usually one year of less. Repayment is typically from ordinary operating income as the need for the loan expires (inventory sold, receivables collected, season ends, etc.).

Credit analysis for a short term loan focuses on the current balance sheet, with a particular emphasis on cash flow and liquidity. These loans, such as lines of credit, are typically secured by accounts receivable and inventory.

Intermediate-term Loans: Intermediate-term loans are used for permanent working capital, machinery and equipment, and similar uses. The loan terms are typically three to seven years for working capital and five to ten years for machinery and equipment, depending on the economic life of the asset being financed. These loans, such as installment and term loans, are generally secured by the asset being financed, accounts receivable, etc.

Long-term Loans: Long-term loans are typically used to finance land and buildings. These loans typically have terms from ten to thirty years. These loans are usually secured by deeds of trusts.

Both intermediate-term loans and long-term loans are used to finance income producing fixed assets (machinery, equipment, buildings, etc.). The loans are expected to be repaid from proceeds generated by the business.

The scope of the credit analysis for these types of loans goes well beyond the current balance sheet. While cash flow and liquidity are still critical, the analysis includes, but is not limited to, measures of profitability, financial strength, debt capacity, management capacity, business plan review, market issues, and collateral. Additional information from other sources may include items such as credit reports, references, industry data/averages.

Each piece of information is used to create an overall picture of the business, the loan request and its feasibility. Personal knowledge of the business, references and credit reports provide a picture of the business owner(s) character. Their experience and management ability can be derived from their resume, and business history. The story of the business (historical and future) is contained in the business plan. The financial statements and financial projections provide information to evaluate the current and projected financial strength, liquidity, and profitability of the business.

Financial Statements

The following is a summary of the key financial statements:

Balance Sheet: Presents the financial condition of a business on a given date. Indicates how well a company manages its financial resources. Should require current (within 60 days) and three prior years.

Income Statement: Measures how well a company buys and sells a product or services to make a profit. Should require current (within 60 days) and three prior years.

Federal Tax Returns: To support and verify income statements (three years required).

Projections: Projections must be accompanied with the assumptions used to generate the figures. Without assumptions the reviewer is significantly handicapped in their analysis.

Income Projections: An estimate of future income and expenses during a period of time (usually a year) to demonstrate debt capacity and profitability.

Cash Flow Projections: An estimate of the cash in-flow and out-flow for the same time period as the income projections. Cash flow projections are used to evaluate liquidity and debt capacity.

Projected Balance Sheet: Is usually shown the day after funding and a specified period in the future (typically one year). It summarizes the impact of the new loan and equity funds on the business.

Aging Schedules: Aging of accounts receivable and accounts payable should be provided according to dates and customer(s).

Schedule of Business Debt: Used as a supplement to the balance sheet by providing more detailed information on outstanding loans and liabilities.

Financial Statement Analysis

The most common techniques of financial statement analysis involve comparisons to current and past years (trend analysis) compared to industry averages.

The following is a brief summary of the various analysis techniques. Exhibit C contains a more detailed discussion on underwriting CDBG loans.

Horizontal Analysis: The intent of horizontal analysis is to reveal changes and trends in either a positive or negative direction. Projected and current financial statements are compared to historical financial statements and industry averages. This comparative analysis is done by "spreading" the financial statements. Large variations in either dollar or percentages should be investigated to determine the cause of the change.

Vertical Analysis: Vertical analysis determines the percentage relationship between certain statement items. Typically on an income statement every item is expressed as a percentage of sales. On a balance sheet each account is expressed as a percentage of total assets.

Ratio Analysis: Individual items of the financial statements are compared with one another, and is expressed as a ratio. Comparison of the ratios with prior years and industry averages are important in evaluating the business.

Several ratios are commonly used, by category, to evaluate the financial strength of the proposal. They are as follows:

Measures of Liquidity: Liquidity ratios evaluate the quality and adequacy of current assets to meet current obligations.

Current Ratio: Current Assets divided by Current Liabilities.

A rough indication of the ability to service current obligations.

Quick Ratio: Cash, Securities, Receivables divided by Current Liabilities

A more conservative measure of liquidity. A ratio of less than 1:1 implies a dependency on inventory to meet current obligations.

Inventory Turnover: Cost of Goods Sold divided by Average Inventory. This ratio indicates the number of times that inventory is turned over during the year.

Days Inventory: Inventory divided by Cost of Goods Sold times 360. Average number of days a unit of inventory is kept on hand.

Days Receivable: Accounts Receivable divided by Sales times 360. This indicates the average number of days receivables are outstanding.

Days Payable: Accounts Payable divided by Cost of Goods Sold times 360. This indicates the average number of days supplier or trade debt is outstanding.

Measures of Profitability: Operating ratios are important in evaluating management performance.

% Profits before Taxes/Tangible Net Worth: Profits or earnings before federal income taxes divided by tangible net worth times 100. This ratio measures the rate of return on equity. (It is multiplied by 100 since it is shown as a percentage).

% Profits before Taxes/Total Assets: Profits or earnings before federal income taxes divided by total assets times 100. This ratio measures the return on assets. It is expressed as a percentage.

Break-even Point (BEP): Fixed costs divided by the contribution margin or

$$\frac{\text{fixed costs}}{1-(\text{variable cost/sales})}$$

The BEP is the volume of sales or the number of units that must be sold so that revenues cover all costs; or break-even is the sales level where profits are zero.

Measures of Financial Strength: Leverage ratios evaluate the measure of protection to creditors.

Debt to Worth: Total debt divided by tangible net worth. This ratio measures the extent to which the owner's equity has been invested in fixed assets. A low ratio indicates better protection for the creditor in case of liquidation.

The C’s of Credit

Aside from the financial analysis, credit decisions are based on other critical, but less tangible, factors. These factors are often referred to as the C’s of credit.

Character: A borrower’s commitment to meet the obligation.

Capacity: Management skills, past experience, key staff, etc.

Capital: **E**quity in the business and in the proposed project.

Collateral: Business and personal assets available to secure the loan.

Condition: The economy and its influences on the company’s financial health, products, services, location, market (trends), competitive position, and expansion.

Coverage: Adequate protection against basic risks, including management succession, key man life insurance, hazard insurance and liability insurance.

The type of loan under consideration determines the scope of the credit analysis. Credit analysis tools reveal trends and comparative values, along with the borrower’s strengths and weaknesses. Credit analysis, including the non-financial information contained in the business plan, resumes, marketing/trade reports and other information will allow the reviewer to reach a sound credit decision.